

EMPLOYMENT TAX AUDIT PROCESS

INTRODUCTION

The California Unemployment Insurance Code (CUIC) and the Government Code authorize the Employment Development Department (EDD) to conduct payroll tax audits of businesses operating in California. The payroll tax audit provides education outreach to employers regarding their state employment tax obligations and ensures that benefit coverage is provided for workers who are entitled to such coverage under the law.

PERIOD COVERED BY THE AUDIT

Generally, EDD employment tax audits cover a three year period, comprising the 12 most recently completed calendar quarters. However, in some situations, such as where no returns are filed, the audit period may be longer.

ENTRANCE INTERVIEW

Before reviewing your records, the auditor will conduct an entrance interview with you or your designated representative to explain the purpose of the audit and the audit process, gather general information about the operation and organization of your business and accounting records, and answer any of your questions.

RECORDKEEPING

Payroll systems can be as basic as a manual system with only a check register and individual earnings records or as complex as a computerized double entry system on an accrual basis. Provisions of the CUIC require employers to keep payroll records providing a true and accurate account of all workers (employed, laid off, on a leave of absence, or an independent contractor) and all payments made. The type of system you use should meet the needs of your business and EDD requirements. (Requirements are further explained in EDD's California Employer's Guide, DE 44.)

SCOPE OF THE AUDIT

The auditor will review your books and records to (see reverse for a list of required records):

- Verify the business ownership and type of entity (sole proprietorship, partnership, corporation, other).
- Verify that all individuals paid for services have been properly classified as either employees or independent contractors in accordance with the provisions of the CUIC and the common law test laid out by the State Supreme Court.
- Discuss any unreported payments made for personal services and the nature of the working relationship(s) with you and the worker(s). Based on the facts obtained from the records, input from you, and discussion(s) with the worker(s), the auditor will determine whether the worker(s) are *employees or independent contractors*.

In addition, if your account has been selected for a complete audit, the following tests will be performed:

- Verification that your acknowledged gross wages and taxable wages have been properly reported.
- Verification that you have correctly withheld and reported Personal Income Tax for wages paid to your employees.

PROVIDING BUSINESS RECORDS FOR THE AUDIT

To expedite the audit process, please ensure that the appropriate records on the reverse are made available to the auditor. If you have been selected for a complete audit, which includes verification of acknowledged payroll, the box for item 2 will be checked and those records will be examined. Otherwise, the auditor's initial examination will be limited to records listed in item 1. If during the limited examination the auditor finds acknowledged payroll issues, the examination may be expanded to a complete audit. To determine the proper classification of workers or payments, additional records may also be required. (For example: invoices, billings, corporate minutes, written agreements, contracts, employee fringe benefits, etc.)

EDD – INTERNAL REVENUE SERVICE (IRS) EXCHANGE AGREEMENT

EDD employment tax audit information is made available to the IRS under an exchange agreement, and the IRS may use the information in the administration of its tax program.

PLEASE MAKE AVAILABLE RECORDS FOR THE PERIOD OF _____

NOTE: An audit begins with the examination of records for a test year. The test year is generally the most recent completed calendar year. If differences are found in the test year, then the examination may be expanded to include the records for the entire period covered by the audit.

1. MINIMUM REQUIRED RECORDS

CUIC Sections 1085 and 1088 require all employing units to make business records available to the EDD.

These records include:

- **Check Registers, Check Stubs, Canceled Checks and Bank Statements**
- **General Ledger and General Journal**
- **Annual Financial Statements (Income & Expense statements, Balance Sheet, etc.)**
- **Cash Payments Records (pay out slips and vouchers)**
- **Ownership Verification**
 - City Business License
 - Board of Equalization Sales Tax License
 - Liquor License
 - California State Contractors License
 - Written Agreements (e.g., Partnership, Articles of Incorporation)
 - Any license required to operate your business
- **Federal/State Income Tax Reports**
 - Federal Income Tax Returns
 - State Income Tax Returns
- **Form 1099 Series, Federal Information Returns and Worksheets**

2. ADDITIONAL RECORDS REQUIRED FOR VERIFICATION OF ACKNOWLEDGED PAYROLL

- **Payroll records such as Payroll Journal, Individual Earnings Records, Payroll Summaries, etc.**
- **Federal Employment Tax Reports**
 - Form W-2s, Wage and Tax Statements
 - Form W-4s, Employee's Withholding Allowance Certificates
 - Form 941s, Employer's Quarterly Federal Tax Returns
 - Form 940s, Employer's Annual Federal Unemployment Tax Returns
- **State Employment Tax Reports**
 - DE 3DPs/DE 3Bs, Quarterly Contribution Return/Report of Wages
 - DE 6s, Quarterly Wage and Withholding Reports
 - DE 7s, Annual Reconciliation Statements
 - DE 678s, Tax and Wage Adjustment Forms
 - DE 4s, Employee's Withholding Allowance Certificates

DISCUSSION OF AUDIT FINDINGS

As part of the audit, the auditor will arrange for an exit interview, either in person or by phone, to review the audit findings, identify any other information that should be considered, and attempt to resolve disputed issues, if any. If you do not reach an agreement with the auditor, you may request a pre-assessment conference with the supervisor of the auditor.

The audit will result in one of three outcomes:

- A no-change audit, where no differences are found;
- An overpayment, where a credit or refund will be issued; or,
- An underpayment, where the differences will be assessed.

APPEAL

If an assessment is issued, you will receive information about your appeal rights. You may petition for re-assessment with an independent third party, the California Unemployment Insurance Appeals Board, for a hearing before an Administrative Law Judge.

PROBLEM RESOLUTION OFFICE (PRO)

If you are dissatisfied with the manner in which the audit was conducted and are unable to resolve the issue with the local Area Audit Office, you may contact PRO at (916) 654-8957.

Equal Opportunity Employer/Program. Auxiliary services and assistance available to persons with disabilities.
